No. 7543 7

IN THE

United States Circuit Court of Appeals

FOR THE

Ninth Circuit

EDMUND J. LORD,
Appellant,
vs.
TERRITORY OF HAWAII,
Appellee.

UPON APPEAL FROM THE SUPREME COURT OF THE TERRITORY OF HAWAII

BRIEF FOR APPELLANT

ROBERTSON & CASTLE
A. L. CASTLE
N. M. NEWMARK
Castle & Cooke Building
Honolulu, T. H.
Attorneys for Appellant

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STATEMENT OF THE CASE

This is an appeal from a judgment of the Supreme Court of the Territory of Hawaii, which affirmed a decision of the Territorial Board of Equalization, sustaining an assessment against the appellant of an income tax for the year 1930 on certain moneys received by him during the year preceding January 1, 1931.

A succinct summary of the undisputed facts is found in the decision of the Supreme Court (32 Haw. 896 at 897-898; Record pp. 24-25), and statements having no record reference are taken therefrom.

E. J. Lord and E. E. Black, having been prior thereto associated in the contracting and building business, in September, 1926, formed a corporation under the name of E. J. Lord, Limited. The corporation had a capital stock of $100,000 divided into 1000 shares, 600 shares of which were issued to E. J. Lord and 400 shares to E. E. Black, each contributing in payment of the stock money or other capital of the value of $60,000 and $40,000 respectively. To comply with legal requirements three other stockholders were named, each as the holder of one share, but these were only nominal or "dummy" shareholders (Rec. p. 202), and in each of the annual reports subsequently filed with the Treasurer of the Territory only Lord and Black were named as shareholders.

The corporation met with a large measure of success and received substantial profits from its operations (Rec. p. 24; see Ex. 28 A, p. 104). At the end of each year the corporation closed its books and determined its profit and loss with the exception of contracts then pending—the credit balance, if any, being then transferred to surplus (Rec. p. 102). The profits so determined were regularly returned in the income tax returns of the corporation, and Territorial income taxes paid thereon (Rec. pp. 106-107).

Late in 1929 the appellant, E. J. Lord, because of ill health, desired to retire from the active pursuit of the business and he and Black began negotiations looking toward the retirement of the former (Rec. p. 56). In consultation with the attorney for E. J. Lord, Limited, E. C. Peters, Esquire, a former Chief Justice of the Territorial Supreme Court, it was agreed, primarily,

that Lord would receive for his stock his original capital contribution ($60,000), plus his share (60%) of the undivided profits (Rec. pp. 57-58), Black's intention being to retire Lord's stock and reduce the capital stock of the corporation to $40,000 thereafter (Rec. pp. 57, 201).

On December 7, 1929, the board of directors of E. J. Lord, Limited, approved the proposal that the corporation redeem the stock of E. J. Lord as planned (Ex. 38 A, Rec. p. 134), and on December 13, 1929, a formal written agreement, giving the corporation an option to reedem the stock, was executed (Ex. 9, Rec. p. 65). This agreement was not with Black but was solely with the corporation, and gave it the right to redeem Lord's stock upon the payment to him of:

(a) A sum of money equal to 60% of the net worth of the company as of December 31, 1929;

(b) A sum of money equal to 60% of the net profits of contracts awarded but not completed on December 31, 1929; any losses to be shared 60-40.

(c) A sum of money equal to 40% of the Territorial and Federal income taxes Lord might become liable to pay as a result of the transaction.

In accordance with the prior action of the board of directors the option was duly accepted.

Sixty per cent of the net worth of the corporation, as of December 31, 1929, was found to be $273,855.36, and pursuant to the option agreement $250,000 was paid on account on February 15, 1930 (Ex. 15, Rec. p. 83), the balance being paid later in the year (Ex. 35, Rec. p. 124). The contracts which were not completed

on December 31, 1929, were all completed in 1930 and final payment to Lord was made prior to the end of that year (Ex. 16, Rec. p. 90), with the exception of a payment of $20,328.50 for his Federal tax liability which was paid early in 1931 (Ex. 29, 30, 35, Rec. pp. 108, 110, 124). Immediately after this latter payment the capital stock of the corporation was reduced to $40,000 (Rec. pp. 119-120).

The total amount paid Lord was $468,219.98, $60,000 of which, representing Lord's original capital contribution, was paid by the corporation out of capital account and the remainder, or $408,219.98, representing Lord's 60% interest in the profits and the surplus of the corporation (but including the sum of $20,328.50, being 40% of Lord's Federal income tax liability), being paid out of surplus (Rec. pp. 115-117).

With respect to that $408,219.98 the Territorial Supreme Court said:

> "It is undisputed that the money paid to E. J. Lord under the contract referred to, other than the sum of $60,000 which came from capital, was actually paid by the corporation out of undivided profits, partly earned prior to the date of the contract and partly earned after the date of contract and that upon all of these undivided profits the corporation had paid the tax of 2% required by law." (Rec. p. 26; 32 Haw. at 898.)

Section 1391, R. L. of Hawaii 1925, which is part of Chapter 103, relating to income taxes, provides that:

> ". . . in assessing the income of any person or corporation there shall not be included *the amount*

*received from any corporation as dividends** upon the stock of such corporation if the tax of two per centum has been assessed upon the net profits of such corporation as required by this chapter, . . ."

Accordingly, in the Territorial income tax return of E. J. Lord for the year 1930, prepared by Mr. H. W. Camp, a tax expert and expert accountant (Rec. p. 145), the sum of $406,569.98 (being $468,219.98 less the $60,000 capital, less a deductible attorneys' fee of $1650 in connection with the transaction), was returned as exempt from taxation as an "amount received . . . as dividends" within the meaning of the above section (Rec. p. 2).

The tax assessor took the view that the transaction was merely an ordinary purchase and sale of stock—just as if Lord had sold his stock to a third person—and levied an assessment on said $406,569.98 as being the net gain derived from the sale of the stock. As a result of this additional assessment the net taxable income of the appellant for the year 1930 was determined to be $398,224.40, and a tax was levied thereon in the sum of $18,686.22 (Rec. pp. 4, 14).

The Board of Equalization—a tax board composed entirely of laymen—sustained the assessment and on appeal to the Supreme Court that decision was affirmed.

SPECIFICATIONS OF ERROR

The appellant relies upon each of the assignments of error filed with his petition for appeal (Rec. p. 282), which are here set forth:

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*All emphasis supplied by us unless otherwise noted.

ASSIGNMENT NO. 1

The Supreme Court of the Territory erred in failing to rule that that part of the consideration received by Edmund J. Lord for the transfer of his stock to E. J. Lord, Limited, over and above his original capital contribution, which represented his theretofore undivided interest in the accumulated earnings, profits and surplus of said corporation, and which was paid out of such earnings, profits and surplus, upon which a Territorial income tax had been assessed and paid, was received as dividends and was exempt for taxation under the provisions of Section 1391, R. L. 1925.

ASSIGNMENT NO. 2

The Supreme Court of the Territory erred in failing to rule that that part of the consideration received by Edmund J. Lord for the transfer of his stock to E. J. Lord, Limited, over and above his original capital contribution, which was paid out of accumulated corporate earnings, profits and surplus upon which a territorial income tax had been assessed and paid, was exempt from taxation under the provisions of Section 1391, R. L. 1925.

ASSIGNMENT NO. 3

If some part of the consideration received by said Edmund J. Lord for the transfer of his stock to E. J. Lord, Limited, was subject to taxation despite the provisions of Section 1391, R. L. 1925, then the Supreme Court of the Territory of Hawaii erred in failing to rule that the tax could be assessed only on the difference between the value of said stock as of January 1, 1930, and the amount which he received therefor.

Assignments Nos. 1 and 2 will be argued under the same general heading. Under Assignment No. 2 it is contended that the entire amount of $406,569.98 (being $408,219.98 less the admitted deduction of $1650) is exempt from taxation, while under Assignment No. 1 it is contended that at least $386,241.48 (or $406,569.98 less $20,328.50—the latter sum being the amount paid for Lord's Federal tax liability) is so exempt.

ANALYSIS OF THE CASE

There can be no question as to the purpose of Section 1391. A state can levy an income tax on the profits of a corporation, and then tax the stockholders again when those same profits are distributed to them by the corporation. Obviously Section 1391 was passed to prohibit this form of "double taxation"—to use the term loosely—and to definitely provide that where a corporation had paid the tax on its profits those same profits, when distributed to the stockholders, should not again be taxed.

In *Matsons Ford Bridge Co. v. Commonwealth,* 117 Pa. 265, 11 Atl. 813, all of the property and franchise of a corporation was taken by eminent domain and the corporation divided the damages, $75,000, among its stockholders. The Pennsylvania capital stock tax was measured by dividends. The state levied a tax on the theory that $30,000—being the excess of $75,000 over the original capital of $45,000—was a dividend.

The assessment was sustained, and in the course of its opinion the court said:

> ". . . The design of the act of 1879 is accurately stated by the learned judge of the court below: 'The theory of the act is that the profits realized

> by the corporation, whether directly arising from its operations from year to year, or from the increase in the value of its property from whatever cause, will sooner or later reach the pockets of its stockholders; and that when they do, they furnish a fair measure of the value of the capital stock, and therefore of the amount of tax which it ought to pay.'" (11 Atl. at 814.)

An identical principle applies to the statute under consideration. The theory of Section 1391 is that sooner or later the profits of a corporation will reach the hands of the stockholders, and when they do, they should not again be taxed.

That does not mean that just because profits are paid out to a stockholder they are tax free, nor that there is an exemption only where regularly declared annual "dividends" are paid. The test under the statute is whether the particular amount paid, which may represent either current or accumulated profits, is or is not received "as dividends"—that is, as the stockholder's distributive share of profits. The question in the case at bar is simply whether this transaction was an ordinary sale of stock at a fixed price—in which event the mere fact that part of the consideration was paid out of profits would be immaterial—or whether the undisputed evidence shows that the corporation paid out, and Lord received, a certain amount of money in the transaction as his distributive share of, or 60% interest in, the profits and surplus of the corporation, i.e., "as dividends."

The issue thus delineated was clearly defined in the opinion of the Supreme Court (32 Haw. 898-899; Rec. p. 26), the court in effect conceding the correctness of

the foregoing analysis. It stated, as we have, that the main question was, "What was the nature of the transaction between the corporation and Lord?" (32 Haw. at 899; Rec. p. 27), and that the question of what was actually done was "necessarily in large measure a question of the intention of the parties." (32 Haw. at 904; Rec. p. 33.)

In its decision the Court analyzed the option agreement of December 13, 1929, and the records of the corporation, apparently to determine whether or not there was any reference in the written agreement or records to the distribution in question as a "dividend." Finding none, it ruled in favor of the government on the theory that "irrespective of what the parties might have accomplished if they had pursued a different course, the transaction as it actually occurred was a sale and purchase and resulted in a profit to Lord in the sale of his stock." (32 Haw. at 905, Rec. p. 35.)

Though in effect conceding that formalities were not necessary to have a given distribution be a dividend (infra p. 27), the court actually looked at the form of the transaction and disregarded its substance. While admitting that the intention of the parties was controlling, it looked only at the formal documents to see how they had described the transaction and, in so doing, overlooked that:

> "A formal resolution is not the only evidence of corporate action. Young v. U. S. Mortgage & Trust Co., 214 N. Y. 269, 108 N. E. 418. Everything that was said and done, the entire setting of the occasion, may help in determining the authorization intended to be conferred and the purpose to be carried out and effected. Catholic Foreign Mis-

> sion Soc. of America v. Oussani, 215 N. Y. 1, 109 N. E. 80 Ann. Cas. 1917A, 479." (*In Re Norton's Will,* 224 N.Y.S. 77 at 87.)

We submit that when that rule is applied, and the setting of the transaction, the intention of the parties, and the circumstances under which this distribution was made are all considered, it will be clearly seen that the transaction was not an ordinary sale of stock at a price supposedly representative of its value, but that part of the consideration paid Lord for his stock was paid to him *as his distributive share of the profits in the corporation,* i.e., "as dividends."

We should like to make it clear that no question of reviewing conflicting evidence or disturbing any findings of fact is here involved. The facts are undisputed. The question is simply one of determining the intention of the parties from *all* of those facts, rather than confining our inquiry to the form of the transaction and to *some* of the facts.

Nor is any question of "local law," or local administrative practice here involved. This is the first case of this nature to come before the taxing officials of the Territory and there was no precedent or administrative practice to follow (Rec. pp. 245-246, 272).

Nor is any question of local statutory construction at issue in this case. In its decision the Supreme Court tacitly conceded that the statute in question could cover the type of transaction in question. On the Supreme Court's own analysis of the problem the question presented is purely and simply: What was the essential character of the transaction in question?—and that is the question which this brief will consider.

But if some question of statutory construction should nevertheless be thought to be involved, we submit that this case would then be governed by *Castle v. Castle,* 267 Fed. 521. There this court refused to be bound by a decision of the Territorial Supreme Court as to whether a dower statute, covering "movable effects in possession," included insurance proceeds, saying:

> "It will be conceded that the Federal courts lean toward the interpretation of a local statute adopted by the local courts; but a question of dower is very broad and clearly of a more general nature than are matters confined merely to local usages." (267 Fed. at 524.)

If that is true in the case of dower *a fortiori* it applies in a case involving dividends.

ARGUMENT

I.

THE TERRITORIAL COURT ERRED IN DISALLOWING APPELLANT'S CLAIM OF EXEMPTION

(Assignments of Error 1, 2).

A.

PART OF THE CONSIDERATION RECEIVED BY APPELLANT WAS PAID BY THE CORPORATION AND RECEIVED BY HIM AS HIS DISTRIBUTIVE SHARE OF THE PROFITS AND SURPLUS OF THE CORPORATION.

The Background of the Transaction.

Prior to the formation of the corporation appellant was a contractor and Black worked for him on a salary

and profit sharing basis (Rec. p. 202). They formed a corporation in which they owned all the shares (three shares out of the total of 1,000 held but not owned by others purely to qualify them as incorporators can be disregarded). Appellant decided to retire from the business and as a means of withdrawal the two shareholders decided to divide the business in the ratio of ownership by Lord getting back his original capital contribution plus his share, 60%, of the net profits.

Black first saw attorney E. C. Peters, the former Territorial Chief Justice, who was at all times acting for E. J. Lord, Limited (Rec. p. 62), and then discussed the matter with Lord. Thereafter, on December 7, 1929, the board of directors of E. J. Lord, Limited, approved the plan of redeeming Mr. Lord's stock on the terms thereafter set forth in the formal written option of December 11, 1929 (Appellant's Ex. 38-A, Rec. p. 34).

The discussions of Mr. Black and Mr. Lord, relative to the redemption by the corporation of the latter's stock, as stated by attorney E. C. Peters,

> "resulted in an agreement between the corporation, on the one hand, and Mr. Lord on the other, that Lord was to receive what he had originally put into the corporation by way of contribution on the original organization, and that he was to also receive the undivided profits, which, with the capitalization, would represent the net worth of the business, and that net worth was to be computed as of the close of the year 1929, December 31st." (Rec. pp. 57-58.)

Furthermore, as the closing items for the year 1929 would not disclose Lord's interest in the contracts

which the corporation then had pending—the profits on which were not computed until the acceptance of the same by the government—Mr. Lord, consistent with the general scheme to divide the profits in accordance with the respective interests, claimed that he was entitled to a percentage of profits that might accrue from those contracts (Rec. pp. 59-60). This was agreeable to Mr. Black so long as Mr. Lord would agree to share any losses (Rec. p. 60).

To again quote from the testimony of attorney Peters:

> "So that on the 11th of December, 1929, at the time that this consultation was had with Mr. Lord and Mr. Black, it was agreed primarily that Mr. Lord was to receive sixty per cent. of the net worth of the business as it was disclosed at the end of the year, and sixty per cent. of the profits that might accrue upon those contracts, a list of which Mr. Buchholtz was to furnish." (Rec. p. 60.)

The manner in which the parties themselves viewed the transaction is thus set forth in the testimony of Mr. Black:

> "*Q.* And the idea was then to pay Mr. Lord in the matter of the redemption of the stock his capital contribution plus his share of the earnings in the company?
>
> "*A.* That is quite right, and the contracts pending." (Rec. p. 201.)
>
> . . . .
>
> "*Q.* And in 1929 you desired to own your own business and proposed to Mr. Lord to buy him out?
>
> "*A.* That's right. I would not say particularly 'buy' because the whole assets of the com-

> pany were divided sixty-forty as best we could. I agreed with Mr. Lord to take the plant as he was going out of the contracting business, and that value was established and with the bonds and cash we had that prorated sixty-forty." (Rec. p. 203.)
>
> . . . .
>
> "It was just a division of the assets of the company, plant, stock, bonds and cash, sixty-forty. That is what it amounted to." (Rec. p. 204.)

The intention of the parties thus disclosed shows that the transaction was to be the very antithesis of an ordinary sale at a fixed price, but included the essential element of a dividend—the distribution of profits as such.

Bearing in mind that the agreement of December 13, 1929, was intended to be a summation of the prior understanding of the parties, we turn to a consideration of that document and of what was done pursuant thereto.

The Agreement of December 13, 1929 (Ex. 9).

This document, after reciting that the corporation, party of the second part, desired to redeem the stock of Mr. Lord, stated that the latter was willing to accept and the former to pay therefor

> "A sum of money equal to sixty per cent (60%) of the net worth of the party of the second part as of December 31, 1929, and a sum of money equal to sixty per cent (60%) of the net profits yet to accrue to the party of the second part by its completion of the respective works contemplated by certain executory contracts to which the said party of the second part is a party, remain-

ing uncompleted, and the further sum of money equal to forty per cent (40%) of the amount to which the party of the first part may become liable to the United States of America and/or the Territory of Hawaii for income taxes upon income accrued and/or to accrue to him by reason of and resulting from the exercise by the party of the second part of the option hereby granted and the consummation of the sale of said six hundred (600) shares of the capital stock of said party of the second part." (Rec. pp. 66-67.)

It further provided that as the net worth of the corporation could not be determined until the books had been closed for the year 1929 and an audit made thereof (Rec. p. 67) and as there were certain incompleted contracts with the government (Rec. p. 67), the corporation would cause its books to be closed as of December 31, 1929, and cause the same to be audited, and complete the pending contracts (Rec. p. 69).

The agreement also provided that 60% of the net worth of the corporation as of December 31, 1929, should be paid upon the exercise by the corporation of the option granted in the document, but if that amount exceeded $250,000 the amount of excess over that sum could be retained until the completion of what was known as the St. Louis Heights contract (Rec. p. 71). It further provided that the 60% of the net profits on incompleted contracts should be paid when the profits therefor were received by the corporation, and that the 40% of the Federal and Territorial income taxes should be paid immediately upon assessment of such taxes (Rec. p. 71).

Under the terms of the agreement Lord was to deliver his stock, endorsed by way of pledge, to the cor-

poration to be held by it as security for the consummation of the deed, the corporation being empowered to cause the stock to be redeemed (Rec. p. 68). A further provision was made for arbitration in case of dispute (Rec. p. 72).

It should be remembered that this agreement was made pursuant to authorization of the board of directors of E. J. Lord, Limited (Ex. 38-A, Rec. p. 134) and therefore every step of the transaction was brought to the attention of and approved by that board (Ex. 38-B, Rec. p. 135; Ex. 38-C, Rec. p. 138; Ex. 37-D, Rec. p. 199; and Ex. 131, Rec. p. 131).

The Consummation of the Deal.

Pursuant to the action of the board of directors on December 7, 1929, the option was duly accepted by the corporation. 60% of the net worth of the corporation, as of December 31, 1929, was determined to be $273,855.36, and under the terms of the agreement $250,000 was paid on account on February 15, 1930 (Ex. 15, Rec. p. 83). The final payment, in accordance with the option agreement, was deferred until the completion of the pending contracts.

Upon completion of those contracts and the determination of the profits thereon final payment was made. Appellant's Exhibit 33-A-B (Rec. p. 114) graphically shows the details of the transaction:

TAXPAYER'S EXHIBIT 33-A-B

STATEMENT SHOWING ANALYSIS
OF $468,219.98
Distributed to E. J. LORD BY E. J. LORD, LTD., OUT OF CAPITAL AND SURPLUS.

Surplus Balance 12/31/29, plus 1930 profits (excluding 1930 Dividends)	676,032.63
Less Net Amount of 1930 profit not subject to 60% apportionment (as Exhibit -A-) attached	35,380.17*
	$640,652.46
60% of above $640,652.46 due E. J. Lord	$384,391.48
Plus Allowance for miscellaneous Equipment Charged to Contract Expense	3,500.00
Plus Allowance of 40% of Income Tax (as per Agrmt.)	20,328.50
Portion of SURPLUS distributed to E. J. Lord	$408,219.98
60% of CAPITAL distributed to E. J. Lord	60,000.00
TOTAL DISTRIBUTION TO E. J. LORD (re 600 shares)	$468,219.98

The $3500 allowance is explained by Exhibit 37-D (Rec. p. 199). As testified by attorney Peters, Lord would not accept the book value of the plant and equipment because some of the articles had been entirely written off, yet really had some value (Rec. p. 58). Lord claimed $12,000 as his 60% interest in the plant items which did not appear in the books, and on August 13, 1930, as shown by said Exhibit, the board of directors of E. J. Lord, Limited, authorized a compromise of his claim by payment to him of $3500.

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* This represents profits on contracts entered into after the option agreement, in which Lord did not share.

The $20,328.50 figure represents a payment of $26,904.66 for 40% of the estimated Federal taxes, less a refund of $6,576.16 upon recomputation of the tax (Rep. p. 118, Ex. 30, 35, Rec. p. 110, 124). This sum was not paid until 1931 and held up the final consummation of the deal.

To record the transaction the bookkeeper of E. J. Lord, Limited, opened up an "E. J. Lord Settlement Account" and a "Treasury Stock Purchase Account" (Rec. pp. 107-109, Exs. 29, 30).

We submit that from the time of the first agreement between Lord and Black, and their conference with attorney Peters, the intention of the parties was clearly and logically carried out. Each step of the transaction and each distribution of profits, moreover, was approved by the board of directors of E. J. Lord, Limited, and when the deal had been completed the corporation had distributed to Lord, as shown by Exhibit 33-A-B, his original capital contribution, plus 60% of the profits and surplus of the corporation, including the $3500 item there referred to, plus the $20,328.50 for tax liability.

If the parties had desired simply a purchase and sale of the shares of stock they would have taken into consideration all elements that determine the *value* of stock in a going concern—the position of the corporation in the contracting business, general business conditions, the possibility of the award of lucrative contracts in the near future, etc.—and on that basis would have reached an agreement to pay a fixed sum for the stock. But this is neither what they wanted or intended. The significant thing about the entire

transaction is that there never was any attempt by the parties to reach and agree upon that value. The corporation was not making an ordinary purchase of its stock at a fixed price, as U. S. Steel might do were it to buy shares in the market to reduce its capital; what E. J. Lord, Limited, was attempting to do was to distribute to Lord his original capital contribution, plus his 60% interest in the surplus, and this is exactly what they ultimately did do, plus an equitable agreement on taxes resulting therefrom.

This was a perfectly straightforward transaction, without an attempt at either tax evasion or tax avoidance, and the intention of the parties in making the distribution in question is too clear for further argument.

But the Supreme Court seized on the fact that this agreement did not in so many words say "60% of capital plus 60% of profits" (as had been agreed by the parties), saying:

> "The parties declared that it was a sale and a purchase; they declared that a part of the consideration should be a sum of money equal to sixty per cent of 'the net worth of the corporation,' *which net worth must have necessarily included capital as well as undistributed profits, and they did not, in that connection, distinguish between the two; . . . . . .*" (Rec. p. 33.)

This argument is not worthy of serious refutation, as even in the law things equal to the same thing are equal to each other.

The net worth of a corporation is simply the surplus of its assets over its liability. The capital of any cor-

poration, plus its accumulated surplus, is always equal to its net worth. Therefore sixty per cent of the net worth of E. J. Lord, Limited, was in fact sixty per cent of its capital plus sixty per cent of its accumulated surplus. As stated by attorney Peters, Lord was to receive "what he had originally put in the corporation by way of capital on the original organization, and that he was to also receive the undivided profits which, with the capitalization, would represent the net worth of the business" . . . . . (Rec. p. 57).

The reason that the agreement was drawn as it was, rather than as the Supreme Court apparently would have demanded to recognize the essential character of the distribution, was explained by attorney Peters. According to good bookkeeping, certain plant articles had been wiped off the inventory so that if the books were taken as a standard these would not appear; however, the machinery and equipment was still in existence and still being used, and Lord wanted to have a real determination of its net worth because such machinery and equipment, though written off the books, might really have some value (Rec. p. 58).

Pursuant to that understanding the $3500 adjustment, representing 60% of Lord's interest in items of plant and equipment which, although written off the books, had some value, was made and approved by the Board of Directors (supra p. 23).

The very fact that this method was followed discloses a manifest intention to divide the actual assets 60-40, rather than "sell out" on any presumed or estimated value of Lord's stock. What the parties were interested in was a distributory something that would

really be a 60% distribution of assets, and were *not* trying to value stock.

The Supreme Court also referred to the fact that part of the consideration was 60% of the net profits on incompleted contracts, saying:

> "They did not say that it should be sixty per cent of the net profits but did say that it should be a sum of money equal to sixty per cent of the net profits. Was the corporation on December 13, 1929, declaring a dividend out of profits not yet earned and which might not be earned for a year longer?" (Rec. pp. 33, 34.)

Now it is common corporate practice to declare dividends at one time payable at a later time, and sometimes payments are made to stockholders of record at a future time. Similarly it is perfectly proper and legal for the board of directors of a corporation, or all of the stockholders, to agree to pay dividends in the future either upon a certain condition or upon there being a certain amount of profits then available for distribution. The only thing a corporation cannot do is to guarantee to pay dividends whether or not there is any surplus at a future time. But in the situations above discussed, and in the case at bar, it is perfectly obvious that any distribution made pursuant to a prior agreement between stockholders and the corporation, or pursuant to formal action of the board of directors, *is* a dividend.

As a matter of fact, far from this being a weak point in appellant's case, that the parties agreed that part of the consideration should be 60% of the net profits on pending contracts is one of the strongest circum-

stances sustaining the claim of appellant that this was primarily a distribution of an amount "received as dividends" rather than an ordinary sale at a fixed price. According to the practice of the corporation, profits on incompleted contracts were not computed or entered on the books even at the end of any year, but no profits were computed or set up in the books until the Government had accepted the contracts and final adjustment could be made. (Rec. p. 60.) Reference to the balance sheet of E. J. Lord, Limited, as of December 31, 1929, a photostatic copy of which was transmitted to this court but which was omitted from the printed record by stipulation of counsel, will show the very large "suspension" account which was carried for these pending contracts. Obviously, therefore, to give Lord only 60% of the book surplus as it appeared at the end of 1929 would give him less than he was entitled to. As a contractor he undoubtedly felt that he had a 60% interest in all contracts pending and in the profits thereof, and as a 60% stockholder he in fact had that right. In order to carry out the intention of the parties and give Lord his real 60% interest in the profits and surplus of the company it was necessary to do one of two things:

(1) To depart from the practice of computing profits only upon completion of the work, and estimate the status of the contracts and estimate the probable profits;

(2) To wait until the profits or losses on those contracts were established before the total amount to be paid could be ascertained.

Had there been any desire just to have the corporation "buy Lord out," or fix a price for the value of his

stock as distinguished from a bona fide attempt to prorate the capital and surplus of the company and give him his distributive share of surplus, the first course would have been chosen. The profits on the pending contracts could have been estimated as of December 31, 1929, and then discounted to arrive at the present worth of those contracts, and the corporation could then have paid Lord such a sum. But that is not what was done. Instead of that the whole consummation of the deal was deferred until the *actual* profits could be determined. The stock to be redeemed was held by the corporation as pledgee under the terms of the December 13, 1929, agreement (Ex. 9, Rec. p. 65 at 69), and the stock could not be fully paid for and the redemption finally effected until the profits on the contracts, incomplete at the end of 1929, had been determined. Obviously, from the standpoint of convenience, the method of paying for the stock in the early part of 1930 was preferable to having the matter drag on as it did, and the very fact that this cumbersome and delayed procedure was utilized shows to what extent the parties were willing to go to carry out what was essentially a sixty-forty distribution of capital and surplus.

In fact, regardless of the decision that may be reached as to the remainder of the money received by Lord, it seems impossible to hold that the sum of $174,036.12 —being his 60% of the profits on contracts pending at the close of 1929—was not received "as dividends." If, in the ordinary course of events the corporation had agreed with Lord and Black to distribute to them, as dividends, all the profits earned on those particular contracts, and had done so, there would have been no

tax on that distribution. The only difference between that situation and the case at bar is that here, because Lord was retiring and Black keeping on, the corporation only agreed to pay Lord his share of the profits. But the mere fact that an equal distribution was not made to Black at the time cannot rob the distribution to Lord of its character as an amount received as dividends (infra p. 29).

There is one point referred to in the decision of the Board of Equalization, which merits brief consideration, and that is the fact that the corporation agreed to pay 40% of Lord's Federal taxes arising from the deal. How this meant that no part of the consideration paid for the stock was "received as dividends," or necessarily characterized the transaction as if it had been an ordinary sale to a third person, was not explained by the Board and was not referred to as a basis of the Supreme Court decision. The only possible significance of this provision of the agreement would be to furnish an argument that the particular sum so paid over ($20,328.50) could not be considered as "received as dividends," because it was not paid on the understanding that it represented Lord's proportionate interest in the surplus of the corporation. Assuming that to be true, it does not vitiate appellant's entire claim for exemption any more than does the fact that $60,000 of the consideration, representing Lord's capital contribution, prevents the balance—i. e., the part really paid as dividends—from being tax free.

If this $20,328.50 payment is looked upon solely as an additional inducement or consideration for the transfer of Lord's stock it may be conceded that that part of the consideration was not paid or received as

dividends. This would only result in diminishing appellant's claim of exemption from $406,569.98 to $386,241.48.

But we submit that even this part of the consideration is exempt from taxation. There is no reason why upon redemption of stock the corporation had to give Lord exactly his 60% share of the profits, for the simple reason that by agreement between the stockholders dividends can be declared in any proportion desired (infra p. 29). If income taxes were to result from the distribution, and such distribution was mutually desired, it was only equity that taxes resulting therefrom should be borne in the same proportion. This particular payment meant only that Lord was getting a trifle more than his 60% interest and, since it was paid out of surplus, it should be considered as a distribution in the nature of a dividend.

In *F. G. Lamb,* 14 BTA 814 the practice of a corporation had been to pay out of surplus the Federal taxes assessed upon the corporate income distributed to the two principal stockholders. An assessment against these payments as "dividends" was sustained. There the taxpayer argued that the payments could not be dividends because they "were not formally declared in these amounts," because they "were not intended to be dividends nor were they treated as such by the stockholders or the corporation," and because the payments "were not in proportion to stock holdings" (p. 819).

But it was squarely held that since earnings or profits could be distributed without the formality of a declaration of dividends the mere fact that the div-

idends were not in proportion to the stock holdings was immaterial.

But whatever conclusion this Court reaches as to this particular item of $20,328.50 cannot affect the question of whether the remaining moneys, over and above the return of capital, were received as dividends.

B

THAT AMOUNT WAS THEREFORE RECEIVED AS DIVIDENDS WITHIN SECTION 1391, R. L. 1925.

The normal case to which the statute in question applies is that where a going concern makes periodical disbursements to its stockholders, tagged as a "dividend." There are only two points of difference between the instant case and that typical situation:

(1) That some of the profits here involved had been accumulating for several years;

(2) That there was no formal declaration of a dividend.

But these differences are differences of form, not of substance.

As to the first, it is clear that the term "dividends" includes extraordinary as well as current distributions out of surplus, *Thayer v. Burr,* 119 N. Y. S. 755 at 757; and as stated in *Trefry v. Putnam,* 222 Mass. 522, 116 N. E. 904 at 912:

> "The extra cash dividend was declared out of surplus earned which had accumulated during 23 years previous to March 1, 1913. Although it was

> large and had been accumulating for a long time, it was not the less a cash dividend. It came to the shareholder as his individual property for the first time when declared and paid in 1916. It was not in substance or effect a distribution of capital."

It is equally clear that no formalities are required to have a dividend; the only essential is that it be a distribution of profits.

The term "dividends" is "a word of very general and indefinite meaning," has no "particular and technical signification" and is really synonymous with "distributive shares." *University v. N. C. R. R. Co.,* 76 N. C. 103, 22 Am. Rep. 671 at 672. Actually the term connotes a *division* or *distribution.* Cf. *Eyster v. Centennial Board,* 94 U. S. 500, 24 L. Ed. 188 at 189, where the court was speaking of a liquidating distribution of assets to stockholders and said:

> "Such a division produces a dividend; that is to say, a part or share of the thing divided. If the division is of profits, then the dividend is of profits; if of capital, then of capital."

Usually, of course, dividends are formally declared from time to time by the Board of Directors, and distributed to all of the stockholders. But neither of these attributes is an essential of a dividend. Whenever a division of profits is made, then, regardless of formality, and regardless of whether the distribution is *called* a "dividend," it *is* a dividend.

Spencer v. Lowe, 198 Fed. 961, 966 (8th C.C.A.);
Smith v. Moore, 199 Fed. 689, 692, 697 et seq. (9th C.C.A.);

Hartley v. Pioneer Ironworks, 181 N. Y. 73, 73 N. E. 576, 577;

In re Norton's Will, supra;

People v. Travis, 157 N. Y. S. 943, 944-945;

In re Thompson's Estate, 262 Pa. 278, 105 Atl. 273, 274.

Barnes v. Spencer & Barnes Co., 162 Mich. 509, 139 Am. St. Rep. 587, 127 N. W. 752 at 755-756, where it is said:

> "A division of profits is a dividend, even though not called such and not considered such by the directors or stockholders. *Cook on Corporations,* p. 1445, and cases cited."

That is particularly true in the field of taxation where, no matter what form or device is employed, if in fact there has been a distribution of profits there has been a dividend.

Hadley v. Commissioner, 36 Fed. (2d) 543, 544 (App. D. C.):

> ". . . . . it is settled law that the division of profits of a corporation among its stockholders amounts to a constructive dividend whether it is intended by the directors or stockholders to constitute a dividend or not. Chattanooga Savings Bank C.C.A. 17 Fed. (2d) 79; certiorari denied 274 U.S. 751, 47 Supreme Ct. 764, 71 L. Ed. 1332."

Phelps v. Commissioner, 54 Fed. (2d) 289, (7th C.C.A.), discussed infra p. 30.

Chattanooga Sav. Bank v. Brewer, 17 Fed. (2d) 79.

Christopher v. Burnet, 55 Fed. (2d) 527.

Nor is it necessary that the distribution be a pro-rata one, because the stockholders of a corporation can make any agreement they desire with respect to the distribution of profits, and such distributions, whether or not proportional to stock holdings, are dividends.

Joseph Goodnow & Co., 5 B.T.A. 1154 at 1158;
Breslin v. Fries-Breslin Co., 70 N.J.L. 274, 58 Atl. 313, 318;

For applications of the foregoing principles see:

Bone v. U. S., 46 Fed. (2d) 1010:
(Excessive salaries treated as dividends though not proportionate to stock holdings.)

Duffin v. Lucas, 55 Fed. (2d) 786:
(Corporation paying debt of one shareholder.)

Frank A. Taplin, 12 B.T.A. 1264:
("Purchase" by dominant stockholder of part of corporate assets at quarter of their value.)

In fine, a dividend is nothing but a *distribution of profits.* Before such distribution a shareholder has a certain interest in the profits of a corporation; when he gets his share of the profits, by whatever mode, he has received a dividend. As stated in *U. S. v. Phellis,* 257 U. S. 156, 66 L. Ed. 180 at 184:

> "It is the appropriate function of a dividend to convert a part of a surplus thus accumulated from property of the company into property of the individual stockholders; the stockholder's share being thereby released to and drawn by him as profits or income derived from the company."

From the foregoing it follows—and the Supreme Court so conceded—that if the essential characteristic of the transaction in question was the distribu-

tion of profits that any profits distributed as such would be received "as dividends." And, as we have shown, all that happened in the case at bar was that Lord was surrendering his stock for his pro rata share of the capital share and profits of the corporation.

We know of no state cases dealing specifically with the problem here involved. Most of the Federal cases are inapplicable for the reason that almost every Revenue Act has made specific provision for the treatment of cases of retirement of stock or corporate dissolution. Obviously the fact that Congress chose to treat gains derived from these transactions in a certain way—either as dividends or as capital gains—sheds no light on the question now at issue.

But where, as in the 1921 act, Congress failed to provide specifically for this situation it was uniformly held that where stockholders received accumulated profits from the corporation upon retirement of their stock, or upon liquidation of the corporation, such profits so received should be taxed as "dividends" and that the capital gain sections had no application.

As stated in *Bisbee v. Midland Linseed Products Co.,* 19 F. (2d) 24 at 28:

> "In order to make a sale of a capital asset, under the revenue laws in force at the time, (1921) it was necessary to sell to an outside party, or otherwise the International Revenue Department would have treated the transaction as a retirement of the shares and the proceeds as a liquidating dividend. See Internal Revenue Cumulative Bulletin, III, Vol. I, p. 47, I. T. 2034."

The case of *Phelps v. Commissioner,* 54 F. (2d) 289 (7th C.C.A.), cert. denied, 285 U. S. 558, 76 L. Ed. 946,

was decided under the Revenue Act of 1921, and it is submitted that that case should be considered as decisive of that at bar.

In that case, the facts of which are detailed more fully in the Board of Tax Appeals Report in *20 B.T.A. 866,* the W. L. Phelps Company had a common stock of 7500 shares of the par value of $750,000, of which Northern Trust Company, Trustee, owned 2250 shares, W. L. Phelps owned 2550 shares, and Mrs. Phelps, Mrs. Voorhees and one other person each owned 900 shares. This was a family corporation. The board of directors by resolution authorized W. L. Phelps, its president, *"to purchase"* for the corporation shares of its stock *at a price not to exceed $130* a share. Pursuant thereto all of the stock of the corporation was purchased at $130 a share, except 300 shares retained by Mr. Phelps, the corporation not distributing certain real property.

The Board of Tax Appeals found that the "sale of stock" was equivalent *to a surrender of stock by the stockholders for their pro rata share of the assets and surplus* and upheld the assessment of a tax on the theory that the amount of surplus received by the stockholders on surrender of their stock was received as a "dividend," within Section 201 (a) of the 1921 Act. The appeal was taken on the ground that the transaction should have been treated as a gain derived from sales of property under Section 202 of the same Act, the exact position of the Territory in the case at bar.

The Circuit Court of Appeals held, looking through the form of the transaction to its substance, *that the essence of the transaction was not a sale of stock but*

was, to the extent surplus was distributed, *a distribution of profits in the nature of a dividend.*

In that case the corporation had done everything possible to make the transaction look like a sale. Not a word was said about liquidation or about the payment of any pro rata share of surplus; on the contrary, the resolution passed by the board of directors spoke of a sale and purchase of stock, and that at a price not to exceed a certain sum. But this, as the Board of Tax Appeals said, was in legal effect *"to all intents and purposes an agreement among the stockholders to surrender their stock in exchange for a pro rata share of the distributable surplus . . . . ."* (20 B.T. A. at 873), and, as stated by the Seventh Circuit (p. 291):

> "If, under the facts stated, we are bound by the plain meaning of the language employed in the resolution referred to in the statement of facts, then of course the transactions in controversy should be considered as sales, for that is what the resolution termed them, and pursuant thereto there was an exchange of stock for money. But in all relations of life it oftentimes happens that the thing done speaks so audibly that equity is prevented from hearing the language of the parties, and will classify the act by its real name rather than by the name which the interested parties have given it. In such instances the substance of the transaction will control the form, and the Board therefore was warranted in considering both form and substance in arriving at its conclusion. United States v. Phellis, 257 U. S. 156, 42 S. Ct. 63, 66 L. Ed. 180; United States v. Klausner (C.C.A.) 25 F. (2d) 608."

Now in the Phelps case there was a studied purpose on the part of the corporation and the stockholders to

get within the capital gain sections and every act that they did in making the distribution was directed toward that end. In the case at bar, however, there was no such attempt to color the transaction in any way; the parties simply clearly and logically carried out their intention to distribute to Lord his share of the surplus. Yet the Supreme Court, because neither the minutes of the board of directors meeting of December 7, 1929, nor the agreement of December 13, 1929, nor any of the formal records of the corporation, referred specifically to the word "dividend," refused to look at the substance of the transaction and considered it as an ordinary sale!

If in the *Phelps* case the retirement of stock amounted to an agreement of the shareholders "to surrender their stock in exchange for a pro-rata share of the distributable surplus," *a fortiori* that is true in the case at bar.

And if in the *Phelps* case a "dividend" had been received, *a fortiori* an amount had been "received as dividends" in the case at bar.

It may be urged that the Phelps case is not an authority for appellant because the Revenue Act of 1921 had a definition of the word "dividend":

> "Sec. 201. (a) That the term 'dividend' when used in this title . . . . . means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913, except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922."

But this does not subtract anything from the force of that decision. As we have shown, a "dividend" *means* any distribution out of earnings or profits regardless of the manner or form in which it is made, and the only effect of the statutory definition was to prevent dividends being taxed which were declared out of earnings and profits accumulated prior to February 28, 1913—the effective date of the Income Tax Act.

Tax Assessor Hill felt that the distribution in question could not have been received "as dividends" because Black did not receive any equal distribution (Rec. p. 14 at 18), and this seemed to be the main basis of the Board's decision (see Rec. p. 14 at 18).

As pointed out above, however, dividends need not be pro-rata, for stockholders can make any agreement they please about distributing surplus. (Supra p. 29.) If the corporation was trying to pay Lord his share of profits that amount was tax-free whether or not it at the same time gave Black his share. The Supreme Court admitted that if Black had received his pro-rata share that would have been tax-free, though he should immediately re-invest it all in the company (Rec. p. 34). How that would affect the essential character of the transaction between Lord and the corporation, however, is not explained.

In point of fact Black did receive just as much as Lord in the transaction. When Lord was eliminated from the company, Black became the actual, if not the technical, owner of all of the assets of the corporation. The same situation existed and the same contention was made in the Phelps case. There the taxpayer contended that the word "div-

idend" or "distribution" had to be "without reference to any surrender of stock," and since Phelps retained 300 shares, the other distribution could not be a "dividend" or "distribution" because "distributions must be made ratably to all stockholders" (20 B.T.A. at 873). The Board of Tax Appeals, answering these contentions, pointed out that the test of a distribution was not whether or not a stockholder surrendered his stock, nor was it necessary that dividends be pro-rata to stock holdings, and the fact that Phelps retained some stock was immaterial as ". . . . . the 300 shares retained by the president represented only the value of the undistributable property, and *when all other stockholders were eliminated he was left with 300 shares of stock as the sole owner of the corporation and virtual owner of all that remaining property*" (20 B.T.A. 873).

Similarly the Seventh Circuit pointed out that the transaction in question was not primarily a "sale," but the "sale" was only incident to the transaction and, answering the other objection of the taxpayer, said:

> ". . . The fact that Mr. Phelps received money for part of his stock and retained the remaining outstanding stock cannot militate against such conclusion. *He was thereby, in effect, the owner of the undisposed of assets of the corporation, which consisted only of the Jefferson street property.* Technically, as between the stockholders and the corporation, it was not a complete liquidation in the sense that all the assets had been converted into cash and distributed; *but as between the stockholders themselves, for all practical purposes, there was in effect a complete distribution,*

> *which was evidently made by agreement of the parties and one which they were fully authorized to make.* Breslin v. Fries-Breslin Co., 70 N. J. Law, 274, 58-8, 313; Joseph Goodnow & Co. v. Commissioner, 5 B.T.A. 1154; F. G. Lamb v. Commissioner, 14 B.T.A. 814." (54 Fed. (2d) at 292-293.)

That this statement can be accurately applied to the case at bar cannot be doubted.

In its essence the case at bar is indistinguishable from the case of *Commissioner v. Ward,* 65 Fed. (2d) 758 (3rd C.C.A.). There a party withdrew from a building and loan association. The by-laws of the association provided that upon such a withdrawal stockholders should be entitled to their proportionate share of the earnings and surplus of the corporation, and that is what the shareholder in fact received. The transaction therefore was treated as if the shareholder had received a dividend and was not treated as a capital gain, the Court saying, at page 759:

> "We think the profits made and apportioned among the stockholders constituted a dividend of profits. This is so, although the profits were accumulating until the shares matured instead of being declared and paid at regular intervals. See Cary v. Savings Union, 22 Wall. 38, 22 L. Ed. 779."

In the case at bar there is of course no charter or by-law provision corresponding to that of the building and loan association in the Ward case. But a pro-rata share of surplus is what a shareholder of a corporation is entitled to receive upon dissolution of the corporation, or upon his withdrawal therefrom, and in point of fact that is exactly what was intended to be given, and was given, to Lord upon his retirement.

We submit, therefore, that the Supreme Court erred in failing to consider the *substance* of the transaction here involved, and that upon a consideration thereof by this court appellant's claim for exemption should be allowed.

II.

THE COURT ERRED IN HOLDING THE DIFFERENCE BETWEEN THE COST OF APPELLANT'S STOCK AND THE AMOUNT HE RECEIVED THEREFOR WAS TAXABLE.

(Assignment of Error No. 3)

This argument is advanced only if appellant's claim for exemption is denied and the transaction treated as an ordinary sale of stock.

In these days of heavy income taxes it is a commonplace for persons to pay, under the Federal capital gains sections, a tax on the profits derived from the sale of stock, and the profit is measured by the difference between the cost of the stock and the price for which it is sold. This is true, although the stock may have been bought, say in 1926, and sold in 1934. We are prone to assume, therefore, that all taxing systems tax such profits in the same manner, and are liable to lose sight of the fact that unless specific provision is made therefor, no such result normally follows from the sale of stock purchased several years back.

To illustrate: If a man buys stock in 1900 for $50.00, that stock may steadily increase in value until, say in 1913, it is worth $250.00. If at the end of 1913 that stock is sold for $300.00, it is obvious that he has not made a gain *during the year 1913* of $250.00. If he has gained any income at all it would be only $50.00; that

is, he has not gained *during the year 1930* the difference between what he bought the stock for in 1900 and sold it for in 1913, but only the difference between what the stock was worth at the beginning of the taxation period and what he sold it for at the end.

It is submitted, therefore, that the Court erred in holding that in this case a tax could be assessed on the difference between the cost to Mr. Lord in 1926 of his stock, and the amount which he received therefor in 1930.

Unquestionably we are here in the realm of "local statutory instruction" of tax laws. Ordinarily this Court would not upset a decision by the Territorial Supreme Court on such a matter unless manifestly erroneous. In this case, however, the Supreme Court overruled, *sub silentio,* one of its own decisions rendered in 1906, which in turn was based upon a United States Supreme Court decision. Consequently the correctness of the ruling now made should be examined.

In *Castle v. Tax Assessor,* 18 H. 129, one J. B. Castle bought stock in 1898 and sold it in the latter half of 1905 at a profit of $120,000. The taxation period covered the six months prior to January 1, 1906, and it was sought to levy a tax on the $120,000 profit because the stock had been sold during that period. Castle contended, however, that the profit was not taxable because it was not an income "derived during the taxation period in question, namely, from July 1, 1905, to January 1, 1906."

This contention was sustained, the Supreme Court of the Territory saying:

> ". . . . All that the statute attempts to tax is the income derived during a certain period. The

period in question in this case was for the six months prior to January 1, 1906. R. L., Sec. 1278, as amended by Act 87 of the Laws of 1905, provides for a tax on the amount derived 'during the taxation periods as herein defined,' and that the first taxation period 'shall be the half year immediately preceding the first day in January, 1906.' R. L., Sec. 1280, as amended by the same act, provides that in estimating gains, profits and income they shall be derived 'during said taxation period.' The income in question was not derived during the six months preceding January 1, 1906, and therefore was not taxable as gains, profits and income derived during that period. See *Gray v. Darlington,* 15 Wall. 63."

The facts in that case are indistinguishable from those in the case at bar. Similarly the statute then in question is practically identical with the statute under which the present tax was assessed. Section 1278, R. L. 1905, like its successor, Section 1388, R. L. 1925, provided for an *annual* levy on "gains, profits and income" derived (in the first statute) or received (in the second) *during the taxation period.* And Section 1280, R. L. 1905, providing what "income" included, has been carried over into Section 1390, R. L. 1925, *in haec verba* (though the end of Section 1390 now contains an additional proviso which has no bearing on the question now presented).

The *Castle* case, and the United States Supreme Court case upon which it was based, were urged as authority for the taxpayer's contention in the case at bar, but the Supreme Court, repudiating its earlier decision in the *Castle* case, refused to follow the *Darlington* case.

In *Gray v. Darlington,* 15 Wallace, 63, 21 L. Ed. 45, the taxpayer had purchased certain bonds in 1865. In 1869 he sold the bonds at a profit of $20,000, and it was sought to levy a tax against this profit for the year 1869. The Court squarely held that the mere fact that the property had appreciated in value between 1867 and 1869, and that the entire profit was first realized in 1869, did not make that profit a "gain, profit or income" for the year 1869, and that that profit of $20,000 was not taxable. In the course of its opinion, the Court said:

> "The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains,profits, or income of the plaintiff for the year in which the bonds were sold. The answer which should be given to this question does not, in our judgment, admit of any doubt. *The advance in the value of property during a series of years can in no just sense be considered the gains, profits or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property.*" (21 L. Ed. at 46.)

That case was decided under an act of Congress of March 2, 1867, which provided in part:

> "There shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person . . . . . whether *derived* from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, ... or *from any other source whatever,* . . . . . a tax of five per centum on the amount so *derived* over $1000 . . . . . And the tax herein provided for shall be assessed, collected, and paid

upon the gains, profits, and income *for the year ending the 31st of December next preceding* the time for levying, collecting, and paying said tax."

The above section is practically identical with Section 1388, R. L. 1925, which provides:

> Sec. 1388. *Rate on Person's Income.* There shall be levied, assessed, collected and paid annually upon the gains, profits and income received by every individual residing in the Territory, from all property owned, and every business, trade, profession, employment or vocation carried on in the Territory . . . . a tax in accordance with the following schedule on the amount so received *during the taxation period as herein defined:*

Another part of the above quoted section of the Congressional act provided:

> "In estimating the gains, profits, and income of any person, there shall be included all income derived from interest upon notes, bonds, and other securities of the United States, *profits realized within the year* from sales of real estate purchased within the year, or within two years previous to the year for which income is estimated, ... *and all other gains, profits, and income derived from any source whatever.*"

This is the counterpart of Section 1390, R. L. 1925, as amended by Act 133, S. L. 1927, the relevant portion of which provides:

> "Section 1390. Income Includes What. In estimating the gains, profits and income of any person or corporation, there shall be included all income derived from interest upon notes, bonds and other securities, ... ; profits realized within the taxation period from sales of real estate,

> . . . . . ; . . . . . ; the amount of sales of all movable property, less the amount expended in the produce or production of the same, and in case of a person not including any part thereof consumed directly by him or his family; money and the value of all personal property acquired by gift or inheritance, and *all other gains, profits and income derived from any source whatsoever during said taxation period . . . .*"

The whole point of the *Darlington* case is that the advance in the value of personal property over a period of years cannot be considered as a "gain, profit or income" for the particular year in which the sale was made and the gain realized. As stated by the Court:

> "Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital."

In reaching its conclusion in the instant case, the Supreme Court sought to bulwark its conclusion by reference to Section 1390, dealing with the sales of movable property, the court said:

> "The requirement of the statute was that in January, 1931, liability would accrue for taxes on income which was 'received' or 'derived' during the taxation period, which was the year 1930; and this is made even more clear with reference to the sales of movable property when the statute declares that in estimating the profits 'there shall be included . . . . . the amount of . . . . . less the amount expended in the purchase'. The legislature did not, in this connection, make any exception of those parts of the gain in value which did not ac-

crue during the taxation year and the court cannot now make the exception."
(Record pp. 35-36.)

There are several reasons, however, why the section partially quoted from above has no application.

In the first place that portion of Section 1390, R. L. 1925, as amended by Act 133, S. L. 1927, refers only to the sale of *movable* property. While the expression "movable property" may be held to refer to all property which is not real estate, the more usual use of the phrase is to denote *tangible* property rather than intangible property such as shares of stock which do not properly belong in the category of either movables or immovables. The reference in Section 1390 to the consumption of such property shows that only tangible property was meant to be covered by the phrase in question.

In the second place, the Supreme Court itself has held in *Frear v. Wilder,* 25 H. 603, that Section 1390, R. L. 1925, in which the "movable property" phrase appears, does not itself purport to levy any tax or prescribe what is or is not included in the term "gains, profits or income." The only section which does that is Section 1388. Consequently, therefore, if the principle of the *Darlington* case is applied—that the gradual increase in value is not in fact "gain, profit or income" derived or received during the year in which the sale is made, the fact that provisions for treating such a transaction were made in Section 1390 would be immaterial. We refer the Court to the *Frear* case above cited where the exact point was raised and determined.

But the Territorial Supreme Court says that the *Darlington* case has been distinguished, citing *Hayes v. Gauley Mt. Coal Co.*, 247 U. S. 189, at 191-193; 62 L. Ed. 1061, at 1063 (Record p. 36). The Hayes case did not purport to weaken the force of the *Darlington* decision, but simply held that the act then under consideration was so differently worded from the act considered in the *Darlington* case that the latter decision was not controlling.

That the *Darlington* case is still the law appears from the fact that in a case subsequent to the *Hayes* case, to-wit: *Lynch v. Turrish,* 247 U. S. 219 at 230; 62 L. Ed. 1087 at 1093, the Court said, speaking of the *Darlington* case, "This case has not been since questioned or modified."

It was sought in the *Lynch* case to distinguish the *Darlington* case on the ground that the act of 1913 made the income tax one on income "arising or accruing" in the preceding calendar year while the act of 1867 made the income tax one on income "derived," but, as the Court said, while there might be a shade of difference between the words "it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the dispute of purists."

Then follows this language:

> "Besides, the contention of the government does not reach the principle of Gray and Darlington, which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as "arising or accruing," to meet the challenge of

> the words, in the last one of the years, as the government contends, and taxable as income for that year or when turned into cash. *Indeed, the case decides that such advance in value is not income at all, but merely increase of capital, and not subject to tax as income."*

This is exactly the point in the case at bar—that not only should the tax, if any, be based only on the difference between the value of the stock on January 1, 1930, and the amount received therefor, but that in point of fact the gain derived by Mr. Lord was not profit at all but was increase in capital.

There are likewise several striking analogies between the Congressional act under which the *Darlington* case was decided, and the territorial act now in question. Section 1390, as amended, by Act 133, S. L. 1927, provides for profits "realized" within the taxation period from sales of real estate, and provides the exact method of determining the gain where the property is sold either less or more than five years before the sale. So, in the *Darlington* case a similar provision was made for the determination of gains upon the sales of real property. Both statutes contain a general provision requiring all gains, profits and income derived from any source whatever, in addition to the sources enumerated, to be included in the estimate of the assessor. The language of the Darlington case is precisely applicable to the case at bar:

> " . . . . and except, however, in this and similar cases, and in cases of sales of real property, the statute only applies to such gains, profits and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected." (21 L. Ed. at 46.)

Consequently, it is submitted, the Supreme Court of the Territory erred in overruling the *Castle* case, and in failing to follow the *Darlington* case.

We may also mention one certain error in the computation of the tax. The tax is on income derived or received *in 1930.* But the evidence is that the payment of 40% of Lord's Federal taxes—being $20,328.50—was not made until *1931;* (Ex. 29, Rec. p. 108; Ex. 30, Rec. p. 109; Rec. p. 118), hence clearly no tax for the year 1930 was payable on that amount on any theory.

CONCLUSION

So far as appellant's claim for exemption is concerned there is only one question to be determined—should or should not the *substance* of the transaction control the form, and the manifest intention of the parties prevail over their failure to actually mention the word "dividend" in the formal documents? If it should, then clearly the distribution in question is tax-free, as within the letter, spirit and intent of the act in question.

In any event, we submit that it was clear error to tax the gradual gain in value of appellant's stock as a profit for the year 1930.

Respectfully submitted this 10th day of February, 1935.

ALFRED L. CASTLE,

NORMAN M. NEWMARK,

Attorneys for Appellant.